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Louisiana State Taxation of Qualified Subchapter S Subsidiaries: A Proposal

*Susan Kalinka**

In 1996, Congress enacted legislation permitting a subchapter S corporation to form a qualified subchapter S subsidiary ("QSSS").¹ In general, a QSSS is a wholly-owned subsidiary of an S corporation (sometimes referred to as the "S corporation parent") that the S corporation parent elects to treat as a QSSS. For federal tax purposes, a QSSS is not treated as a separate entity, and all of its assets, liabilities, and tax items (items of income, deduction, and credit) are treated as assets, liabilities, and tax items of the S corporation.² Thus, for federal tax purposes, a QSSS is disregarded as a separate entity from its S corporation parent (a "disregarded entity"), and all of the QSSS's tax items are reported on the S corporation parent's informational income tax return (Form 1120S).

The QSSS provisions offer significant benefits to taxpayers. Under state law, a QSSS is a separate corporation for non-tax purposes. Thus, an S corporation may place all of the assets and liabilities of one of its divisions into a QSSS, shielding those assets from liabilities arising out of the operation of another of the corporation's divisions. The liability shield may make it easier for an S corporation to obtain financing for its more profitable divisions. An S corporation also may own chains of QSSSs; for example, where one QSSS owns all of the stock of another QSSS.³ For federal tax purposes, the losses incurred by one QSSS may offset other income of the S corporation, including income attributable to another QSSS owned by the same S corporation.⁴

For Louisiana state income tax purposes, however, there is some question regarding which person or persons are liable for state income tax on the income attributable to the operations of a QSSS. The Louisiana Legislature has not adopted legislation recognizing a QSSS for Louisiana tax purposes. Thus, a QSSS should be treated as a C corporation for Louisiana tax purposes.⁵ A

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1. Small Business Job Protection Act of 1996 § 1308(b), Pub. L. No. 104-188, 104th Cong., 2d Sess. (1996), enacting I.R.C. § 1361(b)(3) (West Supp. 1997).

2. I.R.C. § 1361(b)(3)(A) (West Supp. 1997).

3. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 104th Congress (JCS-12-96), H.R. Rep. No. 244, 104th Cong., 2d Sess., at 120 (1996).

4. I.R.C. § 1361(b)(3)(A) (West Supp. 1997).

5. Actually, the Louisiana Corporation Income Tax Act never uses the term "C corporation." However, the Act distinguishes between "S corporations" and "corporations." For convenience, this article sometimes refers to a corporation that is not an S corporation as a "C corporation."

QSSS is not treated as an S corporation under state law because the Louisiana Corporation Income Tax Act treats a corporation as an S corporation for state income tax purposes only if the corporation is "classified under Subchapter S of the Internal Revenue Code as an S corporation."⁶ A QSSS is not classified as an S corporation under subchapter S of the Internal Revenue Code because the shareholder of a QSSS is a corporation. Subchapter S provides that an S corporation may not have a corporation as a shareholder.⁷

The status of a QSSS for state income tax purposes, however, is not entirely certain. The lack of a provision clarifying the tax treatment of a QSSS for state income tax purposes creates problems for both taxpayers and the Louisiana Department of Revenue and Taxation.

The Louisiana Legislature should address this problem by adopting legislation that will provide rules for taxing the income of a QSSS. The Louisiana Legislature could either adopt a provision that taxes a QSSS as a separate corporation from its parent, or else conform the Louisiana Corporation Income Tax Act to the federal provisions by providing that the tax items of a QSSS flow through to the S corporation parent. The better solution would be to conform the Louisiana tax law to the federal provisions. However, there are additional concerns that should be addressed if the Louisiana Legislature decides to conform state tax law to the federal provisions and treat a QSSS as a disregarded entity under the Louisiana Corporation Income Tax Act.

Part I of this article discusses the issues concerning the taxation of a QSSS's income under the current state income tax. Parts II and III suggest several alternative methods for taxing the income of a QSSS in light of the concerns that must be addressed in drafting QSSS legislation. Part IV discusses QSSS provisions that other states have adopted. Part V offers a proposal that would conform the Louisiana rules for taxing a QSSS to the federal rules.

I. CURRENT TAX STATUS OF A QSSS IN LOUISIANA

For federal income tax purposes, a corporation is a QSSS if the following requirements are met: (1) the corporation is a domestic corporation; (2) the corporation is not an "ineligible corporation" (i.e., a financial institution that uses the reserve method for accounting for bad debts, an insurance company, a corporation for which a possessions tax credit has been elected, or a DISC or a former DISC); (3) an S corporation owns one hundred percent of the corporation's stock; and (4) the S corporation parent elects to treat the corporation as a QSSS.⁸ As was explained earlier,⁹ a QSSS is not an S corporation because the shareholder of a QSSS is a corporation.

6. La. R.S. 47:287.732 (1990 & Supp. 1997).

7. I.R.C. § 1361(b)(1)(B) (West Supp. 1997).

8. I.R.C. § 1361(b)(3)(B) (West Supp. 1997). A "DISC" is a domestic international sales corporation. See I.R.C. § 992(a) (West Supp. 1997).

9. See *supra* note 7 and accompanying text.

Accordingly, for state tax purposes, the income of a QSSS should not flow through to its S corporation parent or to any of the S corporation's shareholders. Nevertheless, it is not entirely certain who is liable for the tax on the income of a QSSS under state income tax law—the QSSS or the S corporation parent's shareholders.

Under a literal reading of the Louisiana Corporation Income Tax Act, a QSSS may be exempt from Louisiana income tax. There are two alternative ways that the income of a QSSS may be subject to Louisiana income tax: (1) the income of a QSSS could flow through to its S corporation parent, as it does under federal tax law; or (2) the QSSS could be subject to Louisiana corporate tax as a separate taxpaying entity. As shown below, neither of these alternatives seems to be possible under the Louisiana Corporation Income Tax Act.

The tax items of a QSSS cannot flow through to its S corporation parent. Section 47:287.732(A) of the Revised Statutes provides that the provisions of the Louisiana Corporation Income Tax Act apply to an S corporation as if the S corporation had been required to file an income tax return with the Internal Revenue Service as a C corporation, in accordance with federal law. Under federal law, a C corporation may not own a QSSS. Where a C corporation owns one hundred percent of the stock of another corporation (the "subsidiary") and does not file a consolidated return with its subsidiary, none of the subsidiary's tax items flow through to the C corporation parent. For state income tax purposes, even if a corporation files a federal consolidated return with its subsidiary, the subsidiary's income is not included on the parent's Louisiana state income tax return.¹⁰ Accordingly, an S corporation should not report any of the QSSS's tax items on its return for Louisiana income tax purposes.

On the other hand, it seems that a QSSS will not report or pay Louisiana corporate income tax with respect to any of its tax items for Louisiana income tax purposes. Because a QSSS is not an S corporation, it should be treated as a C corporation for state income tax purposes. Under the Louisiana Corporation Income Tax Act, a C corporation reports its income in the same manner as it does for federal tax purposes.¹¹ A QSSS does not report any of its income for federal

10. La. R.S. 47:287.733 (1990 & Supp. 1997).

11. Under the Louisiana Corporation Income Tax Act, a corporation generally is taxed on its Louisiana taxable income. La. R.S. 47:287.11(B) (1990). For this purpose, the term "Louisiana taxable income" is defined as Louisiana net income, after the application of a net operating loss adjustment, less a deduction for federal income tax. La. R.S. 47:287.69 (1990 & Supp. 1997). "Louisiana net income" means net income which is earned or derived from sources within the state of Louisiana. La. R.S. 47:287.67 (1990). The "net income" of a corporation is defined as the taxable income of the corporation computed in accordance with federal law for the accounting period and under the same method of accounting (subject to modifications under the Louisiana Corporation Income Tax Act). La. R.S. 47:287.65 (1990 & Supp. 1997). The net income of a corporation is computed by subtracting allowable deductions from the corporation's gross income. Under the Louisiana Corporation Income Tax Act, the "gross income" of a corporation is defined as the same items and same dollar amount required by federal law to be reported as gross income on the corporation's federal income tax return for the same taxable year (subject to modifications under the

tax purposes. Instead, the QSSS's income is reported on the S corporation parent's federal informational tax return¹² and by the shareholders of the S corporation parent on their federal income tax returns.¹³ Since a corporation that is a QSSS does not report any of its income for federal tax purposes, it should not report any of its income for Louisiana state income tax purposes.

A QSSS does not have gross income or taxable income for federal tax purposes because a QSSS's income is treated as the income of the QSSS's S corporation parent. Thus, even if a QSSS were required to file a federal income tax return, it would report no gross income and no net income. Instead, the QSSS's S corporation parent will include on its federal income tax return all of the tax items earned or incurred by the QSSS. Since the Louisiana Corporation Income Tax Act defines a corporation's income by reference to reporting requirements under federal income tax law, it would seem that a QSSS would not report any tax items for Louisiana income tax purposes.

The foregoing conclusion, however, is not absolutely certain. It is unlikely that the Louisiana Legislature intended for a QSSS's Louisiana income to escape taxation under the Louisiana income tax law. Under Section 47:287.61 of the Revised Statutes, a corporation's gross income is defined by reference to the items and dollar amounts that are required to be reported on the corporation's federal income tax return "whether or not a federal income tax return is actually filed." A court could interpret this language to mean that a QSSS, which should be treated as a C corporation for Louisiana state income tax purposes, must report its Louisiana income in the same manner that it would be required to report income on a federal income tax return if it were a C corporation and were required to file a federal income tax return. Similarly, Section 47:287.65, which defines the "net income" of a corporation as the corporation's taxable income computed in accordance with federal law, and Section 47:287.63, defining the "allowable deductions" of a corporation as the deductions from federal gross income allowed under federal law in the computation of the corporation's taxable income, could be interpreted to mean that the net income and the deductions of a QSSS are computed in accordance with federal law applicable to a C corporation. In that case, a QSSS would be required to report and pay income tax to Louisiana on its Louisiana income.

Alternatively, a court could determine that a QSSS is an agent or an alter-ego of its parent S corporation. In that case, all of the QSSS's tax items would be treated as items of the parent S corporation for state income tax purposes, as they are under federal tax law.

The uncertainty under the current law creates obvious problems, not only for the Louisiana Department of Revenue and Taxation, but also for Louisiana

Louisiana Corporation Income Tax Act). La. R.S. 47:287.61 (1990 & Supp. 1997). The "allowable deductions" of a corporation under the Louisiana Corporation Income Tax Act are also defined by reference to deductions allowed under federal tax law. La. R.S. 47:287.63 (1990).

12. I.R.C. § 1361(b)(3)(A) (West Supp. 1997).

13. I.R.C. § 1366(a) (West Supp. 1997).

taxpayers. The Louisiana Legislature should enact legislation specifically addressing the taxation of a QSSS.

II. TREATING A QSSS AS A SEPARATE TAXPAYING ENTITY

Perhaps the simplest solution to the problem is to treat a QSSS as a separate taxpaying corporation for state corporate income tax purposes. The Louisiana Legislature has adopted this approach with respect to corporations that combine their income on a consolidated federal corporate income tax return. Under Section 47:287.733 of the Louisiana Revised Statutes, a corporation that is included with affiliated corporations in a consolidated federal income tax return is treated as if it had been required to file an income tax return with the Internal Revenue Service as a separate corporation. The Louisiana Legislature could adopt a similar provision, stating that:

if an S corporation has made a QSSS election for a corporation in accordance with federal law, the terms and provisions of this Part [the Louisiana Corporation Income Tax Act] shall apply as if the corporation had been required to file an income tax return with the Internal Revenue Service on a separate corporation basis for the current and all prior taxable years, in accordance with federal law.

In that case, it would be clear that a QSSS is treated as a separate entity for Louisiana corporate income tax purposes. Taxing a QSSS as a separate entity, however, has disadvantages. Nonconformity with federal tax law creates accounting complexity for an S corporation and its shareholders. Permitting the tax items of a QSSS to flow through to the S corporation parent and, ultimately, to its shareholders for both federal and state income tax purposes has obvious advantages. Flow-through treatment of a QSSS's tax items would ease the accounting burden of taxpayers who own stock in the S corporation that owns the stock of a QSSS. If the Louisiana Legislature enacts legislation treating a QSSS as a disregarded entity for state tax purposes, taxpayers will be able to report the same income for both federal and state income tax purposes. Conforming the state tax treatment of a QSSS to the federal rules also would ease the administrative burden of the Louisiana Department of Revenue and Taxation in auditing the corporation's state income tax return. Failure to conform the QSSS provisions to federal income tax law will require a QSSS and an S corporation to keep separate books of account for federal and state accounting purposes. If transactions between a QSSS and its S corporation parent are to be recognized for state tax purposes, gains and losses that are recognized on intercompany transactions for state tax purposes will require basis adjustments that will not be made for federal tax purposes.

It is likely that the majority of the other states will treat a QSSS as a disregarded entity under their income tax regimes.¹⁴ In that case, Louisiana's failure to conform its corporate tax law to federal law could encourage S corporations to conduct business in states other than Louisiana where the advantages of the QSSS election are available.

III. ENACTING A QSSS PROVISION IN CONFORMANCE WITH FEDERAL TAX LAW: CONCERNS THAT SHOULD BE ADDRESSED

While it may be more desirable to adopt a provision that would treat a QSSS as a disregarded entity for state tax purposes, there are some important considerations that the Louisiana Legislature should take into account before adopting such a measure. The treatment of an S corporation under the Louisiana Corporation Income Tax Act is designed to address three concerns that may arise with respect to the state's taxation of the income of an S corporation: (1) the avoidance of a rule that would require an S corporation to make a separate subchapter S election for state income tax purposes; (2) the possibility of a constitutional limitation on the state's jurisdiction to tax a nonresident's share of an S corporation's income; and (3) the possibility that a state tax law would cause an S corporation to violate the rule requiring an S corporation to have only one class of stock. Each of the three concerns will be discussed in turn.

A. Requiring a Corporation to File a Separate Subchapter S Election

The Louisiana Corporation Income Tax Act does not require a corporation to make a separate state subchapter S election in order to be treated as an S corporation for state income tax purposes.¹⁵ If a QSSS is to be treated as a disregarded entity for state income tax purposes, the federal QSSS election also should be satisfactory for qualification as a QSSS for state income tax purposes. While a few states require an S corporation to make a separate state subchapter S election,¹⁶ such a requirement imposes an unnecessary burden on taxpayers. If each state required a separate state subchapter S election, an S corporation engaged in business in many states would have to meet multiple filing requirements. Requiring a separate state election also can create a trap for both resident and nonresident taxpayers who are not aware of the rule. If a

14. A number of states already have adopted legislation disregarding the separate existence of a QSSS. See, e.g., Ala. Code § 40-18-160(b)(2) (Supp. 1997); Cal. Rev. & Tax. Code § 23800.5(f) (West 1998); N.Y. Tax Law §§ 208(1-B), 1453(o) (McKinney Supp. 1997); Pa. Stat. Ann. tit. 72, 7301(5.2), 7307, 7307.8(b), 7307.9(e) (West 1992 & Supp. 1998).

15. See La. R.S. 47:287.732 (1990 & Supp. 1997) (providing the state income tax rules that apply to a "corporation classified under the Internal Revenue Code as a Subchapter S corporation").

16. For a discussion of the filing requirements and optional filing requirements that a corporation must satisfy to be considered an S corporation for state tax purposes, see James Edward Maule, Tax Management Portfolio 1510, State Taxation of S Corporations 0008-0009 (1997).

corporation makes a federal subchapter S election, or a federal QSSS election with respect to a wholly-owned corporation, a copy of the election can be filed with the corporation's state income tax return or informational income tax return.

B. Jurisdiction to Tax Nonresident Shareholders

The taxation of an S corporation under the Louisiana Corporation Income Tax Act is designed to ensure that the state of Louisiana may collect tax on a nonresident shareholder's pro rata share of the Louisiana income of an S corporation without violating any real or perceived constitutional limitations on a state's ability to tax nonresidents. Under the Louisiana Corporation Income Tax Act, an S corporation reports its income as if it were a C corporation.¹⁷ Thus, an S corporation must report its Louisiana taxable income.¹⁸ In computing its Louisiana taxable income, however, an S corporation may exclude a percentage of its Louisiana net income.¹⁹ The excludable percentage of Louisiana net income is determined by multiplying the S corporation's Louisiana net income for the taxable year by a fraction, the numerator of which is the number of the corporation's issued and outstanding shares of capital stock that are owned by Louisiana resident shareholders on the last day of the corporation's taxable year, and the denominator of which is the corporation's total number of issued and outstanding shares of capital stock on the last day of the corporation's taxable year.²⁰ For this purpose, the term "Louisiana resident" includes a nonresident shareholder who has (1) filed a correct and complete Louisiana individual income tax return that includes the nonresident shareholder's share of the S corporation's income, and (2) paid the tax due on that income.²¹

The rules concerning the taxation of an S corporation's income permit shareholders of an S corporation to enjoy flow-through taxation and, at the same time, ensure that the state of Louisiana may collect tax on a nonresident shareholder's pro rata share of an S corporation's Louisiana income. Like a partnership, an S corporation is a pass-through entity for federal tax purposes.²² In most cases, an S corporation is not liable for the payment of federal income tax.²³ Instead, each shareholder of an S corporation includes his or her pro rata

17. La. R.S. 47:287.732(A) (1990 & Supp. 1997).

18. La. R.S. 47:287.11(A), (B) (1990).

19. La. R.S. 47:287.732(B)(1) (1990 & Supp. 1997).

20. La. R.S. 47:287.732(B)(2) (1990 & Supp. 1997). For this purpose, no share of stock is counted in the numerator unless its owner has filed a correct and complete Louisiana individual income tax return as a resident for the taxable year of the owner, which includes the last day of the S corporation's taxable year. La. R.S. 47:287.732(B)(2), (3) (1990 & Supp. 1997).

21. La. R.S. 47:287.732(B)(4) (1990 & Supp. 1997).

22. Compare I.R.C. §§ 701, 702 (West Supp. 1997) (flow-through taxation of a partnership) with I.R.C. §§ 1363(a), 1366(a) (West Supp. 1997) (flow-through taxation of an S corporation).

23. I.R.C. § 1363(a) (West Supp. 1997). The Internal Revenue Code, however, imposes a corporate level tax on an S corporation's net recognized built-in gains and excess net passive income in some cases. I.R.C. §§ 1374(a), 1375(a) (West Supp. 1997).

share of the S corporation's items of income, gain, loss, deduction, and credit in the shareholder's federal income tax return.²⁴

The rules under the Louisiana Corporation Income Tax Act are designed to achieve similar results without causing the state of Louisiana to lose revenue with respect to a nonresident shareholder's pro rata share of the S corporation's Louisiana taxable income. For Louisiana income tax purposes, the income of an S corporation flows through to its shareholders.²⁵ Accordingly, the Louisiana income of an S corporation on which the corporation is required to pay state income tax may be reduced by the shareholders' pro rata shares of that income. To ensure that the tax on income that flows through to shareholders will not escape taxation by the state, Louisiana must have jurisdiction to collect the tax from nonresident shareholders.

For a state to impose a tax on a person's income, the person or the income must have a sufficient "nexus" with the state.²⁶ A state may impose a tax on the income of an individual who is a resident of the state, no matter where the individual's income is earned, without violating any principles of federal constitutional law.²⁷ Accordingly, Louisiana imposes a tax on the income of individuals "domiciled, residing, or having a permanent place of abode in Louisiana . . . from whatever source derived."²⁸ Because the tax on income of an S corporation that flows through to Louisiana resident shareholders may be collected without a problem, the Louisiana Corporation Income Tax Act permits

24. I.R.C. § 1366(a) (West Supp. 1997).

25. Louisiana Revised Statutes 47:296(A) imposes an income tax on the Louisiana income of every individual, whether resident or nonresident. Louisiana residents who are individuals are required to pay state income tax on income from whatever source derived, whereas nonresidents are required to pay state income tax on income earned or derived from sources within the state of Louisiana. La. R.S. 47:290(A) (1990). In defining taxable income, income generally is defined by reference to income that must be reported by the individual for federal tax purposes. La. R.S. 47:290(A), 47:293(1) (1990).

26. In *Mobile Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-37, 100 S. Ct. 1223, 1231 (1980), the Supreme Court explained:

For a State to tax income generated in interstate commerce, the Due Process Clause of the Fourteenth Amendment imposes two requirements: a "minimal connection" between the interstate activities and the taxing State, and a rational relationship between the income attributed to the state and the intrastate values of the enterprise.

27. *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 57 S. Ct. 466 (1937).

28. La. R.S. 47:290(B) (1990). To ease the burden of the double taxation that might occur where the income of an individual derived from another state is subject to tax in the state from which the income is derived, Louisiana permits a resident individual to claim a credit against the individual's Louisiana income tax liability for income tax paid to another state with respect to that income. La. R.S. 47:33 (1990 & Supp. 1997). It does not seem, however, that a shareholder of an S corporation who is a resident of Louisiana may claim a tax credit for the taxes imposed on the corporation by another state, regardless of whether the amount of tax is computed with respect to the shareholder's pro rata share of that income. Under Louisiana Revised Statutes 47:33, the credit is allowed only to a resident individual. Where the tax is imposed by another state on the S corporation with respect to the corporation's income, and not on the Louisiana shareholders, a credit will seemingly not be available to the shareholders. No Louisiana cases could be found on this issue.

an S corporation to exclude from its Louisiana taxable income the resident shareholders' pro rata shares of that income.

While a nonresident shareholder is liable for the tax on the nonresident shareholder's pro rata share of the S corporation's Louisiana income under the Louisiana income tax provisions,²⁹ there may be a question as to whether the state of Louisiana has jurisdiction to seek payment of the tax from a nonresident shareholder. The state of Louisiana may tax a nonresident on Louisiana income attributable to a business operated directly by the nonresident in Louisiana without violating constraints on the reach of state taxation imposed by the United States Constitution³⁰ or federal law.³¹ However, there may be a question as to the reach of the state's jurisdiction to tax a nonresident when the income is attributable to a business operated by a corporation in which the nonresident is a mere shareholder.

The United States Supreme Court has held that a state may impose an income tax on a C corporation's distributions to nonresident shareholders of the C corporation's income derived from sources within the state imposing the tax. In *Wisconsin v. J.C. Penney Co.*³² and *International Harvester Co. v. Wisconsin Department of Revenue*,³³ the Supreme Court upheld a tax imposed on a corporation "for the privilege of declaring and receiving dividends" out of corporate income derived from property located and business transacted within the state of Wisconsin.³⁴ The payor corporation was required to withhold and pay tax to the state of Wisconsin on distributions to both resident and nonresident shareholders.

In *International Harvester*, the Supreme Court explained that a state may tax income of a nonresident that is attributable either to property located in the state or to events or transactions that occur within the state. The Court held that a state "may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's . . . activities [within the state]."³⁵

29. La. R.S. 47:290(B) (1990).

30. Where state income taxation is involved, taxpayers may invoke the Commerce Clause or the Due Process Clause of the Fourteenth Amendment. U.S. Const. art. I, § 8, cl.3; U.S. Const. amend. XIV, § 1.

31. *But see* 15 U.S.C.A. §§ 381-384 (West 1984 & Supp. 1997) (prohibiting a state from taxing income derived within the state by any person from interstate commerce, if the only business activities within the state by or on behalf of the person during the taxable year are (1) the solicitation of orders for sales of tangible personal property if the orders are sent outside the state for approval or rejection and if approved, are filled by shipment or delivery from a point outside the state and/or (2) the solicitation of orders in the state in the name of or for the benefit of a prospective customer if the orders by the customer enable the customer to fill the orders by shipment or delivery from a point outside the state).

32. 311 U.S. 435, 61 S. Ct. 246 (1940).

33. 322 U.S. 435, 64 S. Ct. 1060 (1944).

34. 1935 Wis. Laws § 3, ch. 505 (as amended by 1935 Wis. Laws Chapter 552).

35. 322 U.S. at 441, 64 S. Ct. at 1063.

Both *J.C. Penney* and *International Harvester* involved a state tax on corporate distributions.³⁶ The United States Supreme Court has never ruled on the issue of whether a state may impose a tax directly on a nonresident shareholder's pro rata share of the undistributed income of an S corporation that is earned within its borders. There may be a question as to a state's jurisdiction to tax nonresident shareholders on undistributed corporate income.

Two state supreme courts have indicated that such a tax will be upheld. In *Meyer v. Charnes*,³⁷ Colorado sought to tax a nonresident shareholder on distributions from an S corporation. The case was decided in favor of the taxpayer because there was no Colorado statute authorizing the taxation of such distributions. However, in dicta, the Colorado Supreme Court indicated that the state legislature had the authority to enact legislation to tax a nonresident shareholder of an S corporation on income generated by the corporation's Colorado business.³⁸ It seems that the Colorado Supreme Court's rationale for permitting a state tax on a nonresident's pro rata share of the S corporation's Colorado income is that the income of an S corporation is not "passive" dividend income because it is attributable to the shareholder's direct work, including management of the corporation's business.³⁹ This conclusion may be questionable, especially as to a nonresident shareholder, whose distance from the state may impede the shareholder from actively participating in the management of the corporation's business in the state.

In *Kulick v. Department of Revenue*,⁴⁰ the Supreme Court of Oregon held that a state tax on each nonresident shareholder's pro rata share of the distributed and undistributed Oregon income earned by an S corporation did not violate due process because the practical effect of the tax was the same as if the state had imposed a withholding tax on the corporation for the nonresident's share of its Oregon income. The court concluded that the state's demanding that shareholders of a closely-held corporation contribute a tax on financial gains derived from sources within the state did not amount to a demand of the shareholders' property without due process of law.⁴¹ *Kulick*, however, did not involve the state's collection efforts against the nonresident shareholders. It only involved the issue of whether the tax in question was constitutional.

Absent a ruling by a federal court, there is some uncertainty as to whether a nonresident shareholder of an S corporation has a sufficient nexus with a state

36. In *International Harvester*, the Court explained that "[s]o long as the earnings actually arise [within the state], and their withdrawal from the state and ultimate distribution, in whole or in part, to the stockholders are subject to some state control, the conditions of state power to tax are satisfied. . . ." *Id.* at 443-44, 64 S. Ct. at 1065.

37. 705 P.2d 979 (Colo. Ct. App. 1985).

38. *Id.* at 983.

39. See, e.g., *Cohen v. State Dept. of Revenue*, 593 P.2d 957 (Colo. 1979) (subchapter S distributions are not "dividends" for purposes of Colorado state income tax).

40. 624 P.2d 93 (Or. 1981).

41. *Id.* at 98.

to permit the state to impose a tax on the shareholder's pro rata share of the S corporation's undistributed income. States often tax a partner's distributive share of partnership income derived from sources within their boundaries. Unlike an S corporation shareholder, however, a partner may have a sufficient nexus with a state to justify the imposition of a tax. Because a partnership often is treated as an aggregate of its partners, each partner often is deemed to be participating in the partnership's business that is conducted in the state.⁴² In contrast, an S corporation is an entity separate from its owners; for federal tax purposes, at least, the business of an S corporation is not imputed to its shareholders.⁴³ Thus, an S corporation shareholder may not be deemed to be transacting business in a state in which the corporation is transacting business.

Even if a sufficient nexus exists between a nonresident S corporation shareholder and the state to permit the state to impose a tax directly on the nonresident for a pro rata share of the corporation's undistributed income, it may be difficult, as a practical matter, for the state to collect tax directly from the nonresident shareholder. The Louisiana rules are designed to prevent a constitutional objection to the state's jurisdiction to impose a tax on a nonresident shareholder and to avoid the practical problems that may arise in the state's attempt to collect the tax directly from a nonresident shareholder. Accordingly, the state imposes the tax directly on the corporation and allows the corporation an exclusion for income on which the nonresident shareholder voluntarily pays tax.

Legislation concerning the taxation of a QSSS should be drafted to account for the possible limitation on the state's jurisdiction to tax shareholders of an S corporation. Where the shareholder of a QSSS is a nonresident S corporation, there may be an even greater impediment on the state's ability to collect the tax on the income attributable to the QSSS from nonresident shareholders of the QSSS's S corporation parent. If a QSSS is to be treated as a disregarded entity for Louisiana state income tax purposes, the Louisiana Legislature should address the issue of its jurisdiction to tax the nonresident shareholders of a nonresident S corporation on the QSSS's Louisiana income. One way to address the issue is to require the QSSS to pay Louisiana state income tax on its Louisiana income as a C corporation, except to the extent that: (1) the QSSS's S corporation parent includes the QSSS's Louisiana income in its (the S corporation parent's) income; or (2) the resident shareholders of the S corporation parent file Louisiana individual income tax returns and the nonresident shareholders of the

42. See, e.g., *Weil v. Chu*, 501 N.Y.S.2d 515 (N.Y. App. Div. 1986), *aff'd*, 521 N.Y.S.2d 223 (N.Y. 1987), *cert denied*, 485 U.S. 901, 108 S. Ct. 1069 (1988). There is some question, however, as to whether the business of a partnership may be imputed to a limited partner.

43. See, e.g., *Ding v. Commissioner*, 74 T.C.M. (CCH) 708 (1997) (business of an S corporation is not imputed to its shareholders for self-employment tax purposes); Tech. Adv. Mem. 97-20-003 (Jan. 15, 1997) (S corporation's dairy business could not be attributed to a shareholder to allow the shareholder to claim ordinary loss deductions with respect to commodity futures transactions that were entered into to hedge against the cost of the corporation's cattle feed ingredients).

S corporation parent file Louisiana individual income tax returns, reporting and paying Louisiana income tax on their pro rata shares of the S corporation's Louisiana income (including the income of the QSSS that flows through to the S corporation). Such a provision could be modeled after the current S corporation statute to allow a QSSS to exclude its Louisiana income on which the nonresident shareholders of its S corporation parent have paid tax.

Alternatively, the state of Louisiana could require nonresident shareholders of an S corporation to consent to the state's taxing jurisdiction as a condition that must be met for a QSSS to be treated as a disregarded entity for state income tax purposes. Such a requirement, however, would increase the compliance costs for S corporations doing business in Louisiana and could create a trap for the unwary.

Some states have addressed the jurisdictional issue by requiring an S corporation to withhold tax on the corporation's income that is attributable to nonresident shareholders.⁴⁴ If the Louisiana Corporation Income Tax Act were amended to require an S corporation to withhold and pay tax on each nonresident shareholder's pro rata share of the S corporation's income, the state would be able to collect taxes on the nonresident shareholders' shares of the S corporation's income that is attributable to a QSSS doing business in Louisiana.

The withholding requirement, however, creates an administrative burden for an S corporation. If an S corporation is required to pay state income tax on behalf of some, but not all, of its shareholders, the corporation may be required to make distributions to its resident shareholders to correspond to the amount paid to a state on behalf of the nonresident shareholders' state income tax liability. If such offsetting distributions are not made, the corporation is likely to be treated as having more than one class of stock. The only-one-class-of-stock concern is discussed in the following section of this article.

C. The Only-One-Class-of-Stock Requirement

A corporation that has more than one class of stock may not be an S corporation.⁴⁵ If an S corporation had one class of stock when it filed its subchapter S election but later has more than one class of stock, its subchapter S election will terminate on the date that the only-one-class-of-stock rule is violated.⁴⁶ While the Internal Revenue Service has authority to waive an inadvertent termination of a subchapter S election,⁴⁷ there is no certainty that such a waiver will be granted.

Treasury regulations provide that, in general, an S corporation is treated as having only one class of stock if all outstanding shares of stock of the corpora-

44. For the withholding requirements imposed by some states, see Maule, *supra* note 16, at 0094-0096.

45. I.R.C. §§ 1361(b)(1)(D), 1362(a) (West Supp. 1997).

46. I.R.C. § 1362(d)(2) (West Supp. 1997).

47. I.R.C. § 1362(f) (West Supp. 1997).

tion confer identical rights to distribution and liquidation proceeds.⁴⁸ If state law requires an S corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders, the payment or withholding of the tax constitutes a constructive distribution to the shareholder on whose behalf the tax is paid or withheld.⁴⁹ Thus, the withholding of state income tax on behalf of some, but not all, of the corporation's shareholders may confer disproportionate rights to distributions among the shareholders, thereby violating the only-one-class-of-stock requirement.

Where a state imposes withholding requirements on an S corporation, the corporation can avoid violation of the only-one-class-of-stock requirement by distributing proportionate amounts to each of its shareholders to account for the amounts that are deemed distributed to the nonresident shareholders.⁵⁰ Thus, if an S corporation, with one or more nonresident shareholders *and* one or more resident shareholders, does business in a state that requires it to withhold tax on a nonresident's share of the corporation's income derived from sources within the state, the corporation must: (1) determine the amount that has been withheld on behalf of the nonresident; and (2) distribute to the resident shareholders an appropriate amount to ensure that the shareholders' rights to distributions and liquidation proceeds are proportionate to their holdings.

The Louisiana Corporation Income Tax Act seeks to avoid this problem by imposing a tax at the corporate, rather than at the shareholder, level. Section 47:287.732(A) of the Revised Statutes imposes the tax on an S corporation. To allow the corporation's income to flow through to its Louisiana shareholders and to nonresident shareholders who have paid Louisiana state income tax on their share of the corporation's Louisiana income, Section 47:287.732(B) allows an S corporation to exclude the portion of its income for which the shareholders have paid tax.

The method of taxing an S corporation's income under Louisiana income tax law has never been tested with respect to the only-one-class-of-stock rule. It is likely, however, that the corporation's payment of state income tax on Louisiana income that was not paid by its nonresident shareholders will not be treated as a constructive distribution to those nonresident shareholders because, in paying the tax, the corporation satisfies its own obligation.

Under the Louisiana Corporation Income Tax Act, liability for payment of the tax is placed on the corporation, as well as on the nonresident shareholders. In an analogous context, the Service has ruled that where a corporation redeems stock from a retiring shareholder, the fact that the corporation, in purchasing the shares, satisfies the continuing shareholder's executory contractual obligation to purchase the redeemed shares does not result in a constructive distribution to the

48. Treas. Reg. § 1.1361-1(l)(1) (as amended in 1996).

49. Treas. Reg. § 1.1361-1(l)(2)(ii) (as amended in 1996).

50. *Id.*

continuing shareholder, provided that the continuing shareholder is not subject to an existing primary and unconditional obligation to perform the contract.⁵¹

In Revenue Ruling 69-608,⁵² A agreed to purchase all of the outstanding stock of X corporation from X's sole shareholder, B. The contract between A and B provided that it could be assigned by A to a corporation and that, if the corporation agreed to be bound by the terms of the contract, A would be released from the contract. A organized Y corporation to which A assigned the stock purchase contract. Y borrowed funds and purchased B's stock pursuant to the contract. Later, Y merged into X, and X assumed the liabilities that Y incurred in connection with the purchase of B's stock. The Service ruled that Y's purchase of B's X stock did not result in a constructive distribution to A because A was not personally subject to an unconditional obligation to purchase the stock.

It seems that an S corporation's payment of the tax on income that otherwise would flow through to a nonresident shareholder does not satisfy a liability for which the nonresident shareholder has a primary and unconditional obligation to pay. Under Revenue Ruling 69-608, the corporation's payment of the tax should not be treated as a constructive distribution to the nonresident shareholder. Accordingly, the payment of the tax by the corporation on behalf of some, but not all, of its shareholders should not cause the corporation to be treated as having more than one class of stock.

Legislation concerning the taxation of a QSSS should be drafted to avoid causing the S corporation parent to have more than one class of stock. It would be preferable for the state to impose a tax on a QSSS's Louisiana income at the corporate level, allowing an exclusion of income that is included in the S corporation parent's Louisiana income, rather than imposing a withholding requirement with respect to the QSSS's income that flows through to the nonresident shareholders of the S corporation parent. A requirement that an S corporation withhold and pay tax on a nonresident shareholder's pro rata share of the corporation's Louisiana income may not violate the only-one-class-of-stock requirement unless an S corporation with nonresident shareholders fails to make offsetting distributions to resident shareholders. However, such a requirement imposes a burden on an S corporation to ascertain the amount of the required distributions and to make the distributions.

Regardless of whether the Louisiana Legislature adopts a withholding provision or imposes a corporate-level tax on a QSSS's Louisiana income, the language of Section 47:732(A) of the Revised Statutes, which treats an S corporation as if it had been required to file an income tax return with the Internal Revenue Service as a C corporation, must be amended if the income of a QSSS is to be reported by its subchapter S corporate shareholder. Additional

51. Rev. Rul. 69-608, 1969-2 C.B. 43. To avoid a finding of a constructive distribution, the corporation also must not pay more than the fair market value for the stock redeemed. *Id.*

52. Rev. Rul. 69-608, 1969-2 C.B. 44, Situation 6.

amendments may be necessary if the state of Louisiana is to collect tax on the Louisiana income earned by a QSSS that is owned by a nonresident S corporation.

IV. QSSS UNDER THE TAX LAWS OF OTHER STATES

Some states have adopted legislation concerning the taxation of a QSSS.⁵³ The legislation enacted in other states may offer a guide for similar legislation in Louisiana. This section discusses the QSSS rules that apply in Alabama, California, New York, and Pennsylvania, and considers whether similar legislation should be enacted for taxing a QSSS that transacts business in Louisiana.

A. Alabama

Alabama treats a QSSS as a separate S corporation if all of the stock of the QSSS is owned by an Alabama S corporation.⁵⁴ The tax items of a QSSS flow through to its S corporation parent for Alabama income tax purposes because the parent is a shareholder of the QSSS.⁵⁵ If a QSSS is not treated as an S corporation under Alabama tax law, the corporation is an Alabama C corporation⁵⁶ and liable for tax on its income (or Alabama source income, in the case of a nonresident corporation).⁵⁷

Alabama does not require an S corporation to file a separate state subchapter S election in order to be an Alabama S corporation. The term "Alabama S corporation" is defined as: (1) a corporation that has a federal subchapter S election in effect, and its items of income, loss, deduction, or credit affect the Alabama tax liability of any shareholder, either because the corporation does business in Alabama or because stock in the corporation is owned by one or more Alabama residents; or (2) a QSSS, if all of the stock of the QSSS is owned by an Alabama S corporation.⁵⁸

The state obtains jurisdiction to tax a nonresident shareholder of an Alabama S corporation or a QSSS that is treated as an Alabama S corporation by requiring the nonresident shareholder to consent to file an income tax return and pay tax on the nonresident shareholder's share of the Alabama income of an Alabama S corporation and also to be subject to personal jurisdiction in Alabama for

53. See, e.g., Ala. Code § 40-18-160(b)(2) (Supp. 1997); Cal. Rev. & Tax. Code §§ 23800.5(f) (West 1998); N.Y. Tax Law §§ 208(1-B), 660(a), 1453(o) (McKinney 1998); Pa. Stat. Ann. tit. 72, §§ 7301(5.2), 7307, 7307.8(B), 7307.9(E) (West 1998); Wis. Stat. Ann. §§ 71.22(1), 71.365(7), 77.58(3)(a), 77.75(2x) (West 1989 & Supp. 1997).

54. Ala. Code § 40-18-160(b)(2) (Supp. 1997).

55. Ala. Code § 40-18-162 (Supp. 1997).

56. Ala. Code § 40-18-160(c) (Supp. 1997).

57. Ala. Code § 40-18-31 (1993).

58. Ala. Code § 40-18-139 (Supp. 1997).

purposes of collecting the tax.⁵⁹ The Alabama tax law also permits an Alabama S corporation to file a composite (or informational) return and make tax payments on behalf of some or all of its nonresident shareholders.⁶⁰ If an Alabama S corporation fails to file a timely consent of one or more nonresident shareholders, the corporation is required to pay tax on behalf of the nonresident shareholders whose consents have not been timely filed.⁶¹ Thus, the income of a QSSS that is owned by a nonresident S corporation doing business in Alabama will be included in the S corporation's income. Either the nonresident shareholders of the S corporation parent, who have consented to be subject to jurisdiction in Alabama, will pay tax on their pro rata shares of the QSSS's Alabama income, or the S corporation parent, which has consented to be subject to jurisdiction in Alabama, will file a composite return and pay tax on the nonresident shareholders' pro rata shares of the QSSS's Alabama income. Accordingly, the state of Alabama will be assured of collecting the tax on a nonresident shareholder's pro rata share of the S corporation's Alabama income that is attributable to the activities of a QSSS.

To avoid problems that might arise under the only-one-class-of-stock rule, Alabama law treats the corporation's payment of tax on behalf of a nonresident shareholder as a loan from the corporation to the shareholder, payable on demand, and bearing interest at the minimum federal applicable rate.⁶² If the payment by the corporation of tax on behalf of a nonresident shareholder is treated as a loan rather than as a distribution, the corporation's payment should not cause the corporation to be treated as having more than one class of stock because the payment of the tax does not result in shareholders having disproportionate rights to distribution or liquidation proceeds.⁶³

The Alabama rules also address the concerns that otherwise might result from a requirement that nonresident shareholders consent to be subject to jurisdiction and agree to pay tax to the state. Under Alabama law, nonresident shareholder consents are not required as a condition for the corporation to be treated as an S corporation. If such consents are not obtained in a timely manner, the state permits the corporation to satisfy the nonresident shareholders' state tax liability. Louisiana could adopt a similar rule, requiring nonresident shareholders of an S corporation to consent to jurisdiction for collection of state taxes, but permitting the corporation to pay the tax on the nonresident shareholders' pro rata share of the corporation's Louisiana income in lieu of such consents.

59. Ala. Code § 40-18-176(c) (Supp. 1997).

60. Ala. Code § 40-18-176(b) (Supp. 1997).

61. Ala. Code § 40-18-176(c) (Supp. 1997).

62. *Id.*

63. See Treas. Reg. § 1.1361-1(l)(4) (as amended in 1996) (providing safe harbor rules that treat certain instruments, obligations, or arrangements that might be classified as equity for other purposes of the Internal Revenue Code as not violative of the only-one-class-of-stock requirement).

Nevertheless, it may not be advisable for the Louisiana Legislature to adopt provisions for taxing a QSSS that are similar to the Alabama QSSS provisions. While the tax items of a QSSS flow through to the QSSS's S corporation parent and, ultimately, to the parent's shareholders, transactions between a QSSS and its S corporation parent seem to be taxable events. The Alabama tax law seems to treat a QSSS as a separate S corporation. If a QSSS is to be disregarded as a separate entity, it may be preferable to adopt a different approach to taxation of a QSSS in Louisiana.

B. California

California treats a QSSS as a disregarded entity for purposes of the corporate income tax, except that a tax is imposed on the income of a QSSS that is qualified to transact business or is doing business in California.⁶⁴ California tax law also imposes a tax on the income of an S corporation,⁶⁵ in addition to the tax that the shareholders must pay on their pro rata shares of the corporation's income.⁶⁶ To ensure that California may collect any tax from nonresident shareholders on their pro rata shares of the California income of an S corporation, California requires such shareholders to consent to be subject to the jurisdiction of the state of California for the tax.⁶⁷ Since the income of an S corporation parent of a QSSS includes the income attributable to the QSSS's activities, California should have jurisdiction to collect tax from the nonresident shareholders of the QSSS's S corporation parent.

The California method for taxing the income of a QSSS may not be suitable for Louisiana because the taxation of an S corporation in California is so different from the taxation of an S corporation under Louisiana tax law. Moreover, failure of a nonresident shareholder to file a consent to jurisdiction in California is grounds for the retroactive revocation of a corporation's state subchapter S election.⁶⁸ This rule could create a trap for taxpayers who are not aware of the consent requirement. The Alabama rule, which permits the corporation to pay tax on behalf of a nonresident shareholder, creates less risk of an inadvertent termination of a state subchapter S election.

C. New York

Under the New York Tax Law, a QSSS that is owned by a New York S corporation generally is disregarded as a separate entity both for state income tax purposes and for state franchise tax purposes.⁶⁹ If an S corporation is not a

64. Cal. Rev. & Tax. Code § 23800.5(b)(1)(B) (West 1998).

65. Cal. Rev. & Tax. Code § 23802 (West 1998).

66. Cal. Rev. & Tax. Code § 23802.5 (West 1998).

67. Cal. Rev. & Tax. Code § 23801(b)(1) (West 1998).

68. Cal. Rev. & Tax. Code § 23801(b)(3) (West 1998).

69. N.Y. Tax Law §§ 208(9)(k)(1), 1543(o)(1)(A) (McKinney Supp. 1997). New York Tax Law

New York corporation and owns all of the stock of a QSSS, but makes an election to be a New York S corporation, the QSSS also is disregarded for New York tax purposes.⁷⁰ Not only do the tax items of a disregarded QSSS flow through to the shareholders of the QSSS's S corporation parent, but transactions between the QSSS and its parent also are disregarded for New York tax purposes.⁷¹ Where a corporation has in effect a New York subchapter S election, nonresident shareholders are subject to New York income tax on their pro rata shares of the corporation's New York source income.⁷² If a non-New York S corporation parent of a QSSS is not a New York taxpayer and does not have a New York subchapter S election in effect, the QSSS is treated as a C corporation for New York tax purposes.⁷³

The New York rules for taxation of a QSSS may not be suitable for Louisiana. It is not certain whether the New York approach to the taxation of nonresident shareholders on an S corporation's income, which includes the income of a QSSS, will withstand a constitutional challenge. The constitutional limitations on New York's authority to impose a tax on the undistributed New York income of a nonresident S corporation shareholder has never been tested in court. The New York State Tax Commission has ruled that the New York laws concerning the taxation of nonresident shareholders of an S corporation would be presumed to be constitutional at the administrative level⁷⁴ and has suggested that nonresident shareholders of an S corporation who consent to a state subchapter S election thereby consent to being taxed on their pro rata shares of the corporation's New York income.⁷⁵ It is uncertain, however, whether a court would hold that the nonresident shareholders of a nonresident corporation that have consented to the filing of a state subchapter S election may be deemed to have consented to being taxed on their pro rata shares of the income of a nonresident QSSS of the S corporation.

section 1453(o)(2) treats a QSSS as a disregarded entity if its stock is owned by a New York C corporation. This rule may be necessary as the New York Tax Law requires a corporation to make a separate election to be treated as an S corporation for New York tax purposes. The Louisiana Corporation Income Tax Act does not require a state S corporation election. If a corporation has in effect a valid subchapter S election for purposes of the Internal Revenue Code, the corporation is an S corporation for Louisiana income tax purposes. La. R.S. 47:287.732(A) (1990). A corporation that is not classified as an S corporation for purposes of the Internal Revenue Code may not make a QSSS election for a wholly-owned subsidiary. See I.R.C. § 1361(b)(3)(b)(1) (West Supp. 1997) (100% of the stock of a QSSS is owned by an S corporation). Accordingly, it is not necessary for the Louisiana Legislature to enact a provision concerning a QSSS that is owned by a C corporation parent unless the Louisiana Legislature decides to require a corporation to make a separate subchapter S election for state income tax purposes.

70. N.Y. Tax Law §§ 208(k)(3)(A), 1453(o)(3)(A) (McKinney Supp. 1997).

71. N.Y. Tax Law § 208(1-b) (McKinney Supp. 1997).

72. N.Y. Tax Law § 632(a)(2) (McKinney Supp. 1997).

73. N.Y. Tax Law §§ 208(k)(3)(B), 1453(o)(3)(B) (McKinney Supp. 1997).

74. In re Lawrence, TSB-H-79-(47)-I, 1979 WL 5045 (N.Y. State Tax Comm. Feb. 14, 1979).

75. In re Lieb, Advisory Opinion, TSB-A-85-(S)-I, 1985 WL 25431 (N.Y. State Tax Comm. Oct. 22, 1985).

Even if consent to state taxation may be presumed under New York law, consent to taxation on the Louisiana income of a QSSS may not be presumed under the Louisiana S corporation provisions. Unlike the New York Tax Law, the Louisiana Corporation Income Tax Act does not require the shareholders to consent to a separate state subchapter S election for a corporation to be treated as an S corporation for Louisiana state income tax purposes. It is not advisable for Louisiana to require a separate state subchapter S election for a corporation. As was explained earlier,⁷⁶ such a requirement imposes a burden on an S corporation doing business in many states and can create a trap for the unwary.

While the New York method of taxing the income of a QSSS is not entirely suitable for the taxation of a QSSS doing business in Louisiana, the treatment of a QSSS under the New York Tax Law provides a model that may be adapted to Louisiana's approach to the taxation of an S corporation. The Louisiana Legislature could adopt a provision that would permit a QSSS to be treated as a disregarded entity for state income tax purposes only if the QSSS's S corporation parent is a Louisiana corporation. Such a rule, however, may deter nonresident S corporations from conducting business in Louisiana if they wish to conduct an out-of-state venture in QSSS form.

Alternatively, the Louisiana Legislature could permit a QSSS to be treated as a disregarded entity for state income tax purposes if the nonresident S corporation parent and/or the nonresident shareholders of the S corporation parent consent to the state's taxing jurisdiction with respect to the Louisiana income attributable to the QSSS's operations.

D. Pennsylvania

Pennsylvania treats a QSSS as an S corporation if the stock of the QSSS is owned by a Pennsylvania S corporation.⁷⁷ For this purpose, a Pennsylvania S corporation is a small corporation that has a state subchapter S election in effect.⁷⁸ A "small corporation" is a corporation that has a valid federal subchapter S election in effect and does not have passive investment income in excess of twenty-five percent of its gross receipts.⁷⁹ Presumably, a QSSS is treated as a C corporation for Pennsylvania state income tax purposes if its S corporation parent does not have a state subchapter S election in effect.

Pennsylvania asserts its jurisdiction to collect tax on a nonresident shareholder's pro rata share of the Pennsylvania income of a Pennsylvania S corporation by requiring the corporation to withhold and pay tax on such income.⁸⁰ Thus, a Pennsylvania S corporation must withhold tax on a nonresi-

76. See *supra* notes 15-16 and accompanying text.

77. Pa. Stat. Ann. tit. 72, § 7307 (1992).

78. Pa. Stat. Ann. tit. 72, § 7301(n.1) (1992).

79. Pa. Stat. Ann. tit. 72, § 7301(s.2) (1992).

80. Pa. Stat. Ann. tit. 72, § 7324 (1992).

dent shareholder's pro rata share of any Pennsylvania income that flows through to the corporation from a QSSS.

The Pennsylvania treatment of a QSSS is not suitable for Louisiana. As explained earlier,⁸¹ the withholding requirement may cause an S corporation to be treated as having more than one class of stock unless offsetting distributions are made to resident shareholders. Moreover, it is not desirable for a state to require a corporation to make a separate state subchapter S election.

V. PROPOSAL

Unless the Louisiana Legislature wishes to change the way the state imposes tax on an S corporation and its shareholders, any legislation treating a QSSS as a disregarded entity should be consistent with the current state S corporation provisions. Nevertheless, if a QSSS is to be treated as a disregarded entity, it is necessary to amend Section 47:287.732(A) of the Revised Statutes, which requires an S corporation to compute its Louisiana net income as if it had been required to file a federal income tax return as a C corporation. This section provides a proposal for taxing a QSSS that is consistent with the current method for taxing the income of an S corporation under the Louisiana Corporation Income Tax Act, with a few modifications.

Under the proposal, Section 47:732 of the Revised Statutes could be amended to provide:

A. Taxation of S corporation. A corporation classified under Subchapter S of the Internal Revenue Code as an S corporation shall be taxed and required to comply with this Part the same as any corporation. *Except as provided in R.S. 47:287.732(C),* the provisions of this Part shall apply as if the S corporation had been required to file an income tax return with the Internal Revenue Service as a C corporation for the current and all prior taxable years, in accordance with federal law.

* * *

C. Qualified Subchapter S Subsidiary Income. The income of a corporation for which an S Corporation has made a valid election under the Internal Revenue Code to treat the corporation as a Qualified Subchapter S Subsidiary shall be included in the income of the S corporation unless the Qualified Subchapter S Subsidiary is treated as a separate corporation under R.S. 47:287.732.1.

The foregoing provisions generally would require an S corporation to include in its income all of a QSSS's income. In that case, an S corporation could exclude the QSSS's Louisiana taxable income only to the extent that the S corporation's income from all sources, including the income of its QSSS, flows

81. See *supra* notes 45-50 and accompanying text.

through and is taxable to Louisiana resident shareholders, and to the extent that the S corporation's nonresident shareholders pay tax on the QSSS's Louisiana income.

It is not entirely certain that Louisiana has jurisdiction to impose a tax on a nonresident S corporation parent of a QSSS if the S corporation parent is not transacting business in Louisiana. Accordingly, Louisiana should tax the QSSS on its Louisiana income unless its S corporation parent or the parent's shareholders agree to pay tax on the QSSS's Louisiana income. Thus, an additional statute is necessary to reinforce the proposed amendments to Section 47:287.732.

Moreover, the proposed amendments to Section 47:287.732 are not sufficient to treat a QSSS as a disregarded entity for purposes of Louisiana income tax. If a QSSS is to be disregarded as a separate entity from its S corporation parent, all transactions between the QSSS and its parent must also be disregarded. For example, the sale or exchange of property between a QSSS and its S corporation parent should be a nontaxable event. Similarly, no income tax liability should result either to the QSSS or to its S corporation parent on the payment of interest, the discharge of indebtedness, or distributions. Accordingly, the Louisiana Legislature should adopt legislation addressing the taxation of transactions between a QSSS and its S corporation parent.

A new section should be added to the Louisiana Corporation Income Tax Act to provide the rules for state income taxation of a QSSS. The new section could be numbered 287.732.1. The new section concerning the treatment of a QSSS for Louisiana state income tax purposes could be enacted to provide as follows:

§ 287.732.1 Qualified Subchapter S Subsidiaries (QSSSs)

A. Taxation of a Qualified Subchapter S Subsidiary A corporation treated as a Qualified Subchapter S Subsidiary for purposes of the Internal Revenue Code shall be required to comply with this Part the same as any other corporation. The provisions of this Part shall apply as if the Qualified Subchapter S Subsidiary had been required to file an income tax return with the Internal Revenue Service as a C corporation for the current and all prior taxable years in accordance with federal law.

B. Qualified Subchapter S Subsidiary exclusion. This Subsection provides an exclusion to corporations classified as Qualified Subchapter S Subsidiaries under federal law for the taxable year, as follows:

(1) In computing Louisiana taxable income pursuant to this Part, a Qualified Subchapter S Subsidiary may exclude all of its Louisiana net income for the taxable year, provided that the S corporation that owns the stock of the Qualified Subchapter S Subsidiary includes all of the income of the Qualified Subchapter S Subsidiary in computing its net income for the taxable year.

(2) If the Louisiana taxable income of a Qualified Subchapter S Subsidiary qualifies for the exclusion provided in R.S. 287.732.1(b)(1),

the Qualified Subchapter S Subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a Qualified Subchapter S Subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the corporation owning the stock of the Qualified Subchapter S Subsidiary.

(3) If the Louisiana taxable income of a Qualified Subchapter S Subsidiary is excluded under R.S. 47:287.732.1(B)(1) for the taxable year, the S corporation that owns the stock of the Qualified Subchapter S Subsidiary may exclude the percentage of the Qualified Subchapter S Subsidiary's Louisiana net income for the taxable year as is provided in R.S. 47:287.732(B).

If a QSSS is to be disregarded as a separate entity from its S corporation parent for Louisiana state income tax purposes, the Louisiana Legislature may want to consider whether a QSSS should be disregarded for other state tax purposes. For example, should a QSSS be treated as a separate entity for state franchise tax purposes, or should a QSSS's taxable capital be included in the taxable capital of the parent S corporation with respect to which the state franchise tax is computed?⁸² Should sales between a QSSS and its S corporation parent or between two QSSSs that are owned by the same S corporation parent be disregarded for purposes of the Louisiana sales tax?⁸³ A discussion of state taxation for purposes other than the Louisiana state income tax, however, is beyond the scope of this article.

VI. CONCLUSION

The QSSS provisions of the Internal Revenue Code offer planning opportunities that should be available to taxpayers in Louisiana. It is important, however, that the income of a QSSS not escape state income taxation entirely. In drafting legislation to permit Louisiana taxpayers to take advantage of the QSSS provisions, the Louisiana Legislature should carefully consider the possible jurisdictional problems and the practical problems that must be faced in any attempt to collect tax from nonresident shareholders of an S corporation parent of a QSSS. The legislation proposed in this article attempts to address these concerns without requiring an S corporation to file a separate state subchapter S election or a separate state QSSS election.

82. See La. R.S. 47:601(A) (1990) (imposing a franchise tax on the amount of a corporation's capital stock, surplus, undivided profits, and borrowed capital).

83. See La. R.S. 47:302 (1990) (imposing a tax upon the sale at retail, the use, the consumption, the distribution, and the storage for use or consumption of tangible personal property, the rental of tangible personal property, and the sale of certain services).